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Economic Intelligence Weekly

Canada: Inflation Overshadows Good Growth Record

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CANADA: INFLATION OVERSHADOWS GOOD GROWTH RECORD

1. Canada's economic boom, which carried through the first quarter of 1974, is giving way to merely moderate growth. Weakened demand probably will hold the rise in real GNP for the full year to about 4-1/2%, compared with the 1965-73 average of 5-1/2%. No other major developed country has much chance of matching this performance in 1974.

2. Canada has been able to do well despite economic stagnation in most other major industrial nations. The economy has benefited from an investment boom in residential construction and in manufacturing facilities designed to serve the domestic and export markets. Unaffected by the world oil crisis, consumer demand for automobiles and other durable consumer goods has remained strong. Although real demand for exports has slipped, soaring world prices for Canada's raw material exports have provided an ample inflow of foreign exchange. Ottawa thus has been able to continue a moderately expansionary economic policy without worrying about the balance of payments.

3. With the fading of the oil crisis and the acceleration of price increases to an annual rate of 13% in recent months, inflation has become the public's overriding concern. Disagreement on how to deal with price rises percipitated the fall of the Trudeau coalition government in May. The inflation issue likewise is dominating the campaign preceding the 8 July election.

4. Since early polls suggest that voters will not make a clearcut choice between Trudeau's Liberals and the opposition Conservatives, Canada seems headed for another coalition government including the New Democrats as minor partner. Whichever party heads the government, economic policy probably will remain moderately expansionary because the party, in seeking to bolster its position with the voters, will wish to avoid action that would risk jobs. Prospects thus are for only moderate relief from inflationary pressures in the second half. Even the expected 4% growth rate in the second half will not prevent an appreciable rise in the unemployment rate, possibly to a politically damaging 6-1/2% by yearend.

5. In spite of improved terms of trade, we expect Canada's trade surplus (imports f.o.b.) to drop in 1974 to about $1.4 billion – two-thirds that of last year. Export volume probably will dip slightly, since prospects are for reduced deliveries of wheat, crude oil, motor vehicles, and automotive parts. The balance on service transactions should also worsen, but the resulting current account deficit will probably be partly offset by an increased inflow of long-term capital.

The Economy on the Eve of the Election

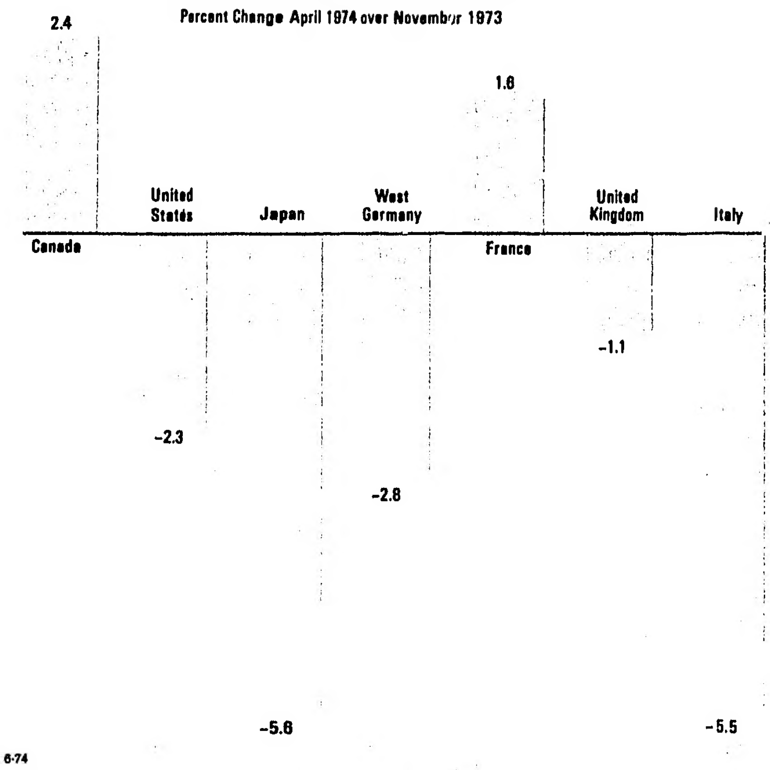
6. Real GNP advanced at a rate of 6% in January-March over the corresponding period of 1973, as a result of increased private investment outlays -- particularly for manufacturing plants and housing – and buoyant consumer

demand. Small losses in real wages were offset by increased welfare payments, by an income-tax indexing scheme designed to maintain real disposable income in spite of rapid inflation, and by strong employment gains. In March the number of employed workers reached 9.1 million, a gain of 150,000 since December.

7. In the current quarter, Canadian economic growth apparently has slowed to about a 4% annual rate because of a slower increase in demand. Through April, only Canada and France – among the major developed countries – had avoided a decline in industrial output (seasonally adjusted) from the November level.

INDUSTRIAL PRODUCTION

Percent Change April 1974 over November 1973



8. The value of Canadian trade is growing much faster than we foresaw a few months ago because prices have risen more than anticipated. The 25% gain in export earnings in January-March from a year earlier was made up of a 30% rise in prices and a 3-1/2% drop in volume. At the same, the continued domestic boom and soaring foreign prices boosted imports by 30%. The first-quarter trade surplus consequently slipped to $320 million from $515 million a year earlier. A strike by St. Lawrence River pilots brought a 10% decline in the value of trade in April, without further damage to the surplus. The huge increase in world oil

prices has had little effect on the trade balance, since the rising cost of oil imports for eastern Canada has been largely offset by price hikes on sales of west Canadian crude to the United States.

9. Heavy inflows of short-term capital from the United States have kept the Canadian dollar strong in spite of a deteriorating basic balance. These inflows have eased since March, when US interest rates turned up again. Although Ottawa has increased its foreign reserve holdings by $400 million since last December to $6.2 billion, the value of the Canadian dollar has climbed from parity with the US dollar to $1.04.

Inflation Woes

10. The good growth record has brought small comfort to the inflation-harassed consumer. The rise in the cost of living hit an annual rate of 11% in the first four months, reflecting mainly higher world commodity prices and wage settlements averaging 11%. Strong domestic demand, fueled by a 14% growth in the money supply through April, contributed to inflationary pressures. In May, higher food and petroleum prices pushed inflation up to an annual rate of 22%, to the dismay of the rank-and-file citizen.

11. The fact that inflation is less severe in Canada than in most industrial nations has done little to temper the issue. In May, rising prices led to increasing friction between Trudeau's Liberals and the New Democratic Party (NDP), their informal coalition partner. The government was toppled when the New Democrats joined the Conservative opposition in voting against Trudeau's proposed budget for fiscal 1975 because it lacked anti-inflation measures. Trudeau already had dismissed NDP demands to hold domestic prices of basic commodities below world market levels and had rebuffed a Tory proposal for sweeping price and wage controls. Instead, he proposed a moderately expansionary budget stressing output and jobs.

Harsh Anti-Inflation Policy Unlikely

12. The new government will confront substantial – though somewhat reduced – inflationary pressures. While food prices should now begin leveling off, rising prices of other raw materials are pushing up other prices. Steel producers, for example, increased prices 12% in May to cover higher raw material costs. Equally important, union militancy is rising as workers attempt to keep pace with inflation. Expected wage settlements yielding 10%-11% increases for the next 12 months will add substantially to unit labor costs.

13. Whether headed by Liberals or Conservatives, the next government will be under considerable popular pressure to do something about prices. But if its hold on the reins of government is precarious, as seems likely, the dominant party will want to avoid a clash on the size of wage settlements as well as responsibility for idling workers through fiscal and monetary constraints. If Trudeau returns to

power, he may opt for selective price controls on a few key consumer goods. The Tories, on the other hand, probably would introduce a 60-90-day wage-price freeze to be followed by a period of flexible controls. At best, only a small reduction in the inflation rate, to 10%-11%, is in prospect for the second half.

Slowing Output Growth and Rising Unemployment

14. Even without restrictive government action, demand pressures are likely to be substantially lower in the second half. Consumer spending clearly is weakening, and private investment outlays show signs of being stretched out. Increased provincial mining taxes last spring are delaying large mining projects, and investors' confidence has been shaken further by the prospect of stiffer federal taxes on mining and petroleum companies. We believe the advance in real GNP will be held to about 4% in the second half, compared with 5% in the first half. Even with this moderate slowing of growth, the jobless rate could climb by one percentage point, to 6-1/2%.

A Small Basic-Balance Deficit

15. The trade surplus for the full year can be expected to show a substantial decline from last year. The drop probably will not be as sharp as in the first quarter, since slowing Canadian output growth will reduce the gain in import volume for the year to perhaps two-thirds of the 1973 rate. We project the increase in the value of exports for the full year at 23% over 1973. The expected small decline in export volume mainly reflects prospects that shipments of crude oil, wheat, and motor vehicles and parts will be appreciably smaller this year than last. Crude oil shipments will continue to be held back by increased domestic requirements, while wheat export sales probably will be depressed by the bad crop weather in May and early June. Automobile sales volume is expected to continue to be hampered by reduced US demand. We believe these declines, together with expected slow growth of sales volumes and easing of prices for metals and minerals, will help to cut the trade surplus to $1.4 billion, $700 million below 1973.

16. Despite a large probable gain in long-term capital inflows compared with 1973, we believe that reduction of the trade surplus will cause a small basic-balance deficit. Our projection is as follows:

	Million US $	
	1973	**1974**
Trade balance	2,131	1,400
Net services	-2,466	-2,700
Current account balance	-335	-1,300
Net long-term capital	667	1,000
Basic balance	332	-300

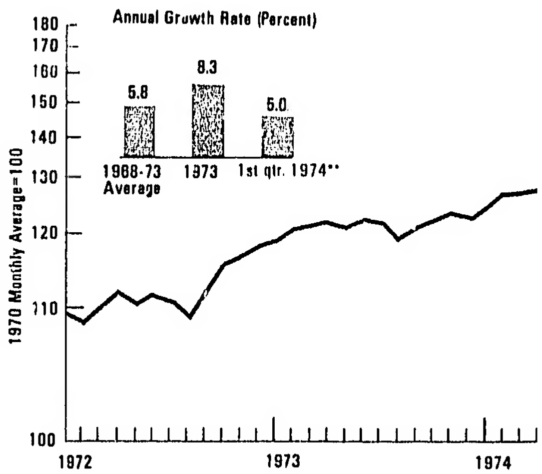
Canada: Projected 1974 Trade

	Value in 19[illegible] (Billion US $)	Projected Increase in 1974 (Percent)			Projected Value in 1974 (Billion US $)
		Volume	Price	Value	
Exports (f.o.b.)	25.2	-2	26	23	31.0
Agricultural and fisheries products	3.3	-7	66	55	5.1
Of which:					
Wheat and wheat flour	1.3	-20	150	100	2.6
Metals and minerals	5.1	3	7	10	5.7
Crude oil	1.5	-35	230	150	3.7
Motor vehicles and parts	5.4	-15	10	-6	5.1
Other manufactures and miscellaneous	9.9	8	7	15	11.4
Imports (f.o.b.)	23.3	8	18	28	29.8
Crude oil	0.9	-4	250	235	3.1
Industrial and construction materials	5.5	7	12	20	6.6
Motor vehicles and parts	6.3	5	10	16	7.3
Capital equipment	5.6	14	7	22	6.8
Consumer goods and miscellaneous	5.0	8	12	21	6.0
Trade balance, customs basis	1.9	....	....	....	1.2
Adjustment for balance-of-payments purposes	0.2	....	....	....	0.2
Trade balance, adjusted	2.1	....	....	....	1.4

(Unclassified)

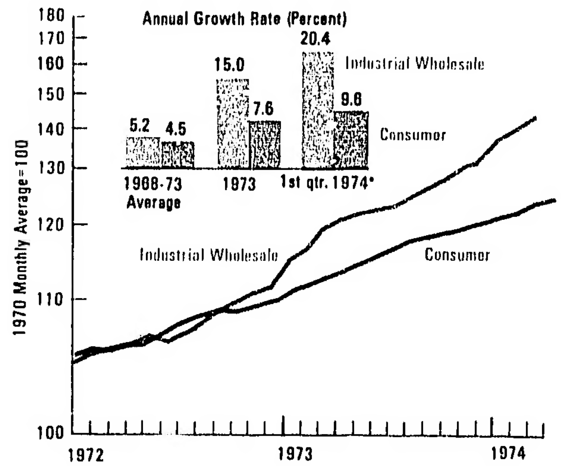
CANADA: INTERNAL ECONOMIC INDICATORS

INDUSTRIAL PRODUCTION*



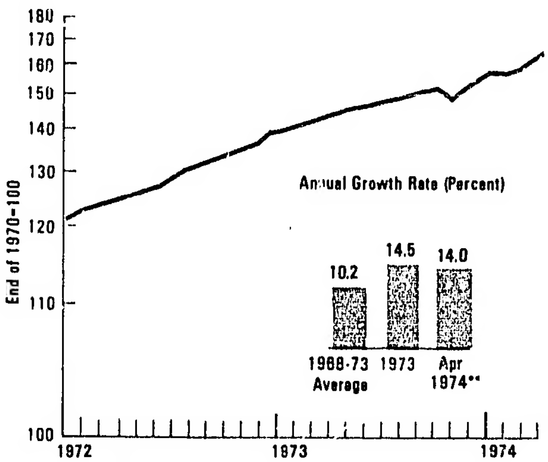
*Seasonally Adjusted.
**Increase over comparable period of 1973.

PRICES



*Increase over comparable period of 1973.

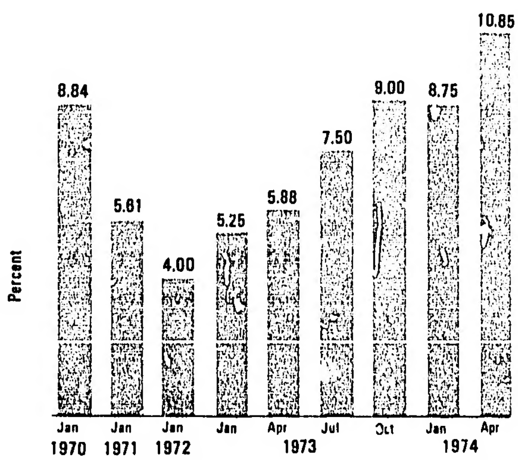
MONEY SUPPLY*



*Seasonally Adjusted.
**Increase over comparable period of 1973.

MONEY MARKET RATES

Interest Rate for Finance Paper



Note: End of period.

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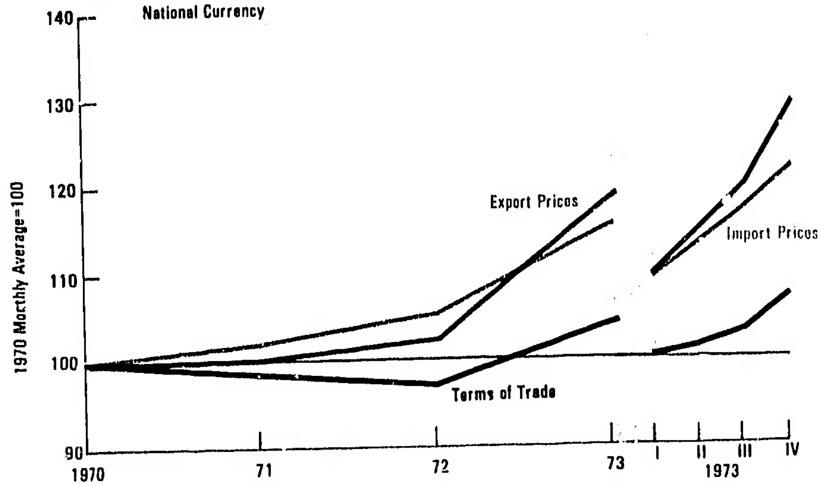
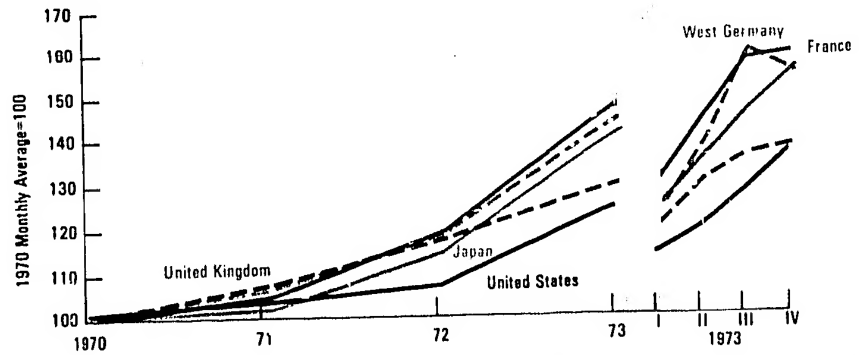
CANADA: EXTERNAL ECONOMIC INDICATORS

TERMS OF TRADE

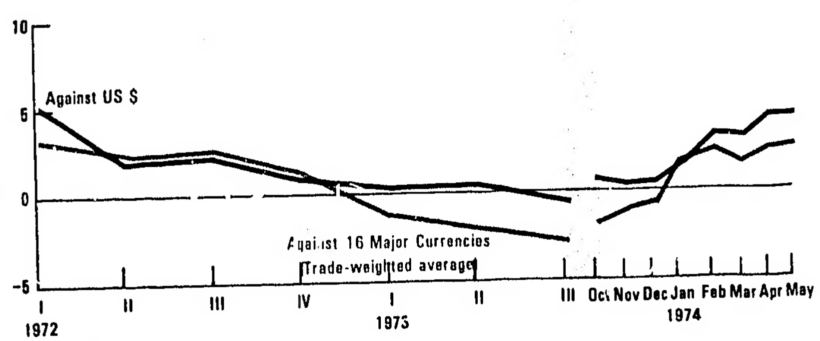


EXPORT PRICES IN US $



EXCHANGE RATES FOR THE CANADIAN DOLLAR

Percent Change from 18 Dec 71



Note: End of Period.

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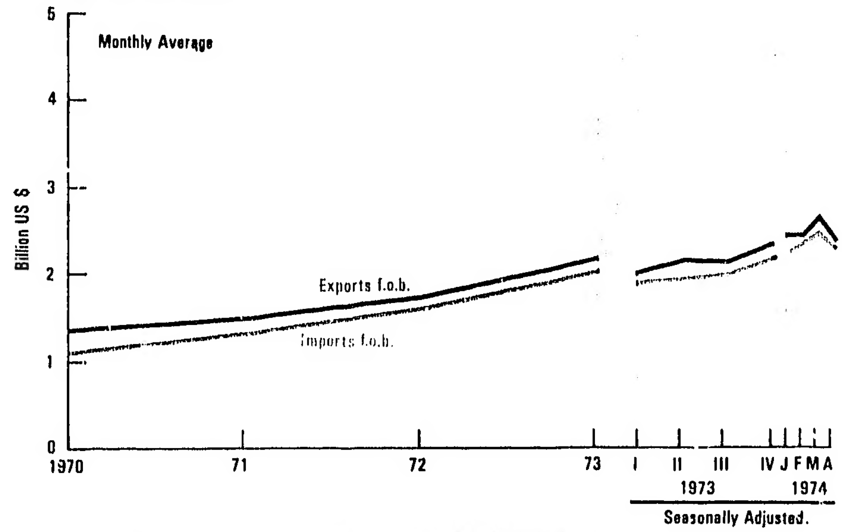
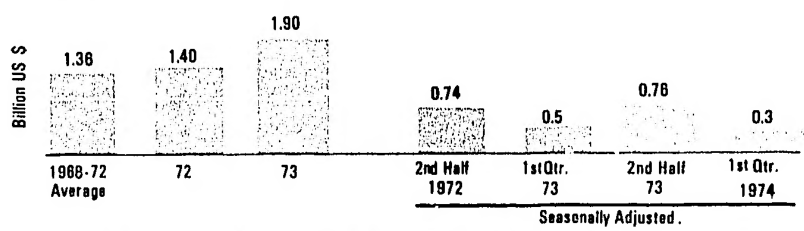
CANADA: EXTERNAL ECONOMIC INDICATORS

VALUE OF TRADE

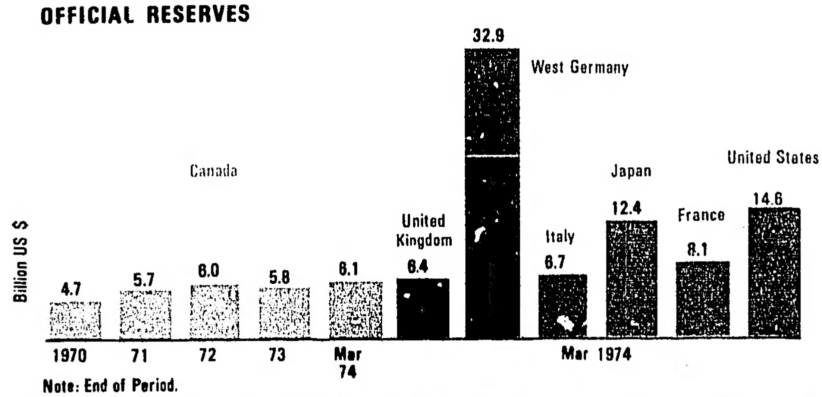


TRADE BALANCE

f.o.b./f.o.b.



OFFICIAL RESERVES



Note: End of Period.

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